

## RESEARCH

**Honolulu City And County, Hawaii; Water/Sewer**

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**Credit Profile**

US\$126. mil Wstwater sys rev bnds (Junior Series) (Second Bond Resolution) ser 2008A due 06/30/2032

<i>Long Term Rating</i>	A+/Stable	New
Honolulu City & Cnty sr wastwtr		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed

**Rationale**

Standard & Poor's Ratings Services assigned its 'A+' rating to the City and County of Honolulu, Hawaii's \$126 million junior-lien wastewater revenue bonds, series 2008A. At the same time, Standard & Poor's affirmed its 'AA-' underlying rating (SPUR) on Honolulu's senior-lien bonds.

Rating factors include:

- The wastewater system's diverse and largely residential service area, serving 71% of the population of Oahu, Hawaii's most populous island ('AA');
- Strong financial performance that has exceeded city council-adopted financial policies that include a debt service coverage target of no less than 1.6x on senior-lien debt and 1.25x on all revenue bond debt;
- Aggressive rate setting actions in support of capital spending requirements; and
- Good cash reserves, supported by a plan to maintain at least three months of operating expenses in reserve.

The above strengths should enable the department to manage a consent decree-driven capital plan that will require \$1.5 billion in financing through 2013.

The bonds are secured by a pledge of net operating revenues of the wastewater enterprise. There are both junior and senior liens that remain open and are expected to be used to finance the system's capital plan. The junior-lien debt is rated 'A+', with the lower rating reflecting the system's leverage position and its considerable additional debt requirements over the next five years.

These 2008 bonds are refunding bonds, issued to convert to fixed from variable interest rate modes, so the system's overall debt is the same as in 2007. The wastewater enterprise had \$724.1 million in senior-lien wastewater revenue debt and \$457 million in junior-lien wastewater revenue debt. There is a combined total of \$1.016 billion in wastewater revenue debt.

The system's very substantial capital needs, \$1.5 billion through 2013, continue to necessitate aggressive rate increases. In support of the system's financial requirements, the Honolulu city council adopted a preapproved package of rate increases in 2005 and 2007. The second package of rate increases, approved in 2007, raised rates above 2005 levels: For example, the rate increases rose to 25% from 10% for 2008 and will increase to 18% from 10% in subsequent years. Rate increases will nearly double the typical household's sewer bill, to \$90 per month in fiscal 2011 from \$55.31 per month in fiscal 2008.

Honolulu expects to issue future debt in support of the capital plan in summer 2009, as it is spending earlier bond proceeds somewhat more slowly than planned. These 2008 bonds are refunding series that will convert variable-rate debt to fixed-rate debt, approximately \$128 million of current and advance refunding.

Debt coverage was strong in 2007, at 2.2x on all revenue debt and 3.0x on senior-lien debt. Projections call for combined junior and senior coverage of 1.25x or better, supported by continued rate increases, and senior coverage is expected to

remain above 2.0x. As Honolulu issues future debt, its annual debt costs are expected to rise to \$162 million. Reserves, supported by policy, have been strong: In 2009 there is \$32.5 million in an operating reserve projected, equal to 155 days worth of operating expenses.

## Outlook

The stable outlook reflects our expectation that the city will be able to afford its very large capital plan by virtue of regular rate increases that should provide adequate revenue to support bonding plans. Critical to the maintenance of the rating will be the city's timely responsiveness of rate setting actions in the event that additional regulatory improvements, such as an upgrade of treatment to "secondary" federal standards, are required.

## Honolulu's Economy Is Performing Well

With roughly 900,000 residents, or 72% of the state's total population, Honolulu is Hawaii's center for economy, government, transportation, finance, and education. Tourism accounts for about 25% of the gross state product, and more than 50% of the state's hotel rooms are located in Honolulu. Waikiki, located adjacent to downtown Honolulu, remains the state's most visited destination. Honolulu's tourism market has rebounded strongly, along with the rest of the state's. The city and island are also anchored by the presence of the U.S. military; there are roughly 34,000 active service men and women on the island, and nearly 15% of the total island population is either employed by or a direct dependent of one of the four branches of the armed services. Unemployment has been steadily declining and was 2.7% in 2005, below the state level and one of the lowest rates for a U.S. city with a population above 750,000. Effective buying income levels are above average for the state but average overall, at 105% and 90% of the nation on a household and per capita basis, respectively.

The continued economic rebound on Oahu has been led by a boom in real estate values after an extended period of weakness during the mid- and late-1990s. Since 2001, total taxable market value has risen by a very strong 86% (or nearly 11% per year, on average), to \$146 billion in fiscal 2007, including very significant increases of 23% and 28% in fiscals 2006 and 2007, respectively. Property values are high on a per capita basis, at \$162,000. Single-family homes account for 61% of this valuation, followed by apartments (22%), commercial (7%), industrial (4%), and hotel and resort properties (only 4%). Historic volatility prior to the recent strong recovery was due primarily to concentration of Japanese capital in the real estate market -- now diminished -- though tourism and second-home investments by domestic "baby boomers" and retirees remain primary drivers for economic growth. Still, the pace of recent increases will almost certainly moderate, as will the potential for rising concerns about affordability and sustainability of currently appreciated market prices.

## Capital Needs Are Substantial

The wastewater system is faced with the challenges of upgrading its collection system, which has been vulnerable to breakages in the past, and plant expansions to accommodate customer growth and peaking needs for wet-weather events. Historically, Honolulu's main treatment facilities -- the Honouliuli and Sand Island plants -- have operated with a waiver from the U.S. Environmental Protection Agency (EPA) that has allowed a lower treatment standard. This waiver was preliminarily denied by EPA and is now being contested by the city. An upgrade to the higher EPA treatment standard would add another \$1.2 billion to the system's capital needs, on top of the \$1.6 billion already required between 2008 and 2012. Most of the financing, 68%, will come from future revenue bonds.

## Departmental Policies Support Financial Stability

The Department of Environmental Services of the City and County of Honolulu was created in 1998 as an enterprise fund to manage the wastewater system. The system serves most of the city and county, except for certain isolated areas that rely on private systems. The system serves more than 600,000 residents, or 71% of the city and county. Average system demand is 113 million gallons per day (mgd), or about 74% of the system's capacity of 151 mgd. Due to relatively slow population growth on Oahu -- projected to total 7% over the next 10 years -- the system's capacity should be sufficient. Management policies adopted by city council set minimum cash reserve levels and debt service coverage levels, such as a three-month operating reserve. Furthermore, rate setting is intended to generate sufficient net available revenues to provide a minimum coverage target of 1.6x senior-lien debt service and 1.25x junior-lien debt service.

### Ratings Detail (As Of 18-Apr-2008)

Honolulu City & Cnty sr lien wstwtr (MBIA)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Honolulu City & Cnty wstwtr sys 2nd res (jr) rev bnds ser 1998 & 2003		
<i>Long Term Rating</i>	A+/Stable	Affirmed
Honolulu City & Cnty wstwtr (wrap of insured) (FGIC & FSA) (SEC MKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Honolulu City & Cnty Wstwtr sys rev bnds (sr Series) (First Bond Resolution) ser 2007ABC		
<i>Long Term Rating</i>	AA-/Stable	Affirmed

Many issues are enhanced by bond insurance.

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